News & Analysis

Liquidity solutions for private funds during a market dislocation

Private funds' liquidity options have evolved in recent years. Davis Polk & Wardwell lawyers Leor Landa, Michael S. Hong and Brantley A. Hawkins explain some of the alternatives to traditional fund financing solutions.

By **Guest Writer** - 20 April 2020

Private fund sponsors considering liquidity options for their investors and portfolios during the covid-19 pandemic should be reassessing their toolkits and exploring the secondary market. Beyond the more traditional fund restructurings and LP tender processes in the GP-led secondary market that have developed over the last several years, we are seeing an increasing desire from sponsors to understand less developed avenues of the market as potential solutions for their financing needs.

Why preferred equity?

A relatively small, but rapidly growing, area of fund financing is the use of fund-level preferred equity structures. In these transactions, a preferred equity provider provides financing for portfolio needs (whether offensive, defensive or opportunistic) or LP liquidity in exchange for disproportionate distributions from the fund or a special purpose vehicle until multiple on invested capital or internal rate of return thresholds are met. The structure can provide flexible capital for sponsors/LPs and attractive returns with high asset coverage for the preferred equity provider, with the potential for continued tail upside participation as well.

Less dependent on portfolio valuation. Sponsors are particularly interested in fund/SPV-level preferred equity structures at this time of market

dislocation and wide valuation spreads because the valuation of the underlying portfolio is a less determinative deal term.

Typically, the preferred equity provider will offer capital at approximately 33-50 percent of preferred-to-value ratio, based on the preferred provider's view of valuation. As long as the cash amount offered by the preferred equity provider is sufficient to cover the offensive, defensive, opportunistic and/or liquidity needs of the sponsor, the transaction can move forward notwithstanding any disagreement between the sponsor and the preferred provider about the portfolio valuation.

Highly flexible. Preferred equity structures can be easily tailored to the needs of the sponsor, the existing LPs and/or the portfolio. They can take into account appropriate timelines and they can involve only specific assets. In a preferred equity structure, the proceeds received by the fund from the preferred equity issuance can be used for a range of solutions (*e.g.*, cash distribution to existing investors or financing an equity injection at the portfolio company level), with a bias towards keeping the value in the fund complex and using it for offensive or defensive portfolio purposes. The existing investors retain exposure to the portfolio upside after the preferred provider has achieved its return. Typically, the preferred provider retains a small slice of that tail upside as well.

Speed. With a volatile market and rapidly developing global crisis, transaction speed is key. And compared to the traditional GP led secondary market, preferred equity can move on a quicker timeline, gated primarily by the need for LP and lender consents.

Realization horizon. As an alternative to a debt financing, the capital raised through preferred equity is most often paid back as realizations on the underlying portfolio happen, rather than through scheduled loan repayments, which should allow the sponsor to focus and operate on their investment timeline without worrying about generating cash for coupon payments. Also, preferred equity structures tend to have few, if any, restrictions, covenants, accelerations, or other similar features of bank debt.

Why not preferred equity?

Cost. Conversely, precisely because of the absence of scheduled prepayments, security, acceleration and other covenants, preferred equity structures are often more expensive than bank debt alternatives. Sponsors pay for the flexibility that preferred equity can provide and the ability to work closely with a secondary fund to craft a suitable product, rather than pulling a more traditional solution off the shelf.

Conflicts. While the conflicts in preferred equity are mitigated relative to the traditional GP-led secondaries market, the creation of separate classes of equity interests in an existing vehicle can skew alignment between the sponsor and certain classes of interests, with such conflict being exacerbated, for example, if the portfolio decreases in value or if the sponsor has acquired a stake (equity or carry) in the preferred equity – which puts a premium on transparency and disclosure to existing investors while implementing a preferred equity structure.

Consents from existing LPs. Implementing preferred equity usually requires investor consent, which can be a gating issue on execution timing. Investors may be more reticent to approve because of an unfamiliarity with the product and the fact that the preferred equity market is not as well developed as other more traditional GP-led secondary processes. In addition, outside of amendment rights for the existing fund documentation, existing investors are not typically given individual options in regards to their participation in a preferred equity structure – contrast this with a fund restructuring where existing investors more often than not have the ability to elect on an investor-by-investor basis whether their investment will be cashed out or rolled into the next structure.

Consents from existing lenders. Sponsors need to diligence any existing fund-level credit facilities to ensure that it can co-exist with a preferred equity structure. Restrictive covenants should be a focus, but sponsors should also be prepared to consider how the preferred equity capital will fit into the borrowing base of the facility or as security thereunder, if at all. We have also seen cases where, with added negotiation, lenders for existing fund facilities are brought into the preferred equity class. This diligence goes hand-in-hand with a close examination of the borrowing provisions under

existing fund documentation to confirm the preferred equity structure is not incidentally captured under those caps.

Shared waterfall and JV structures

Beyond preferred equity structures, sponsors are also contemplating SPV structures that allow the prospective buyer and the sponsor to bridge the gap in valuations by allowing the sponsor to retain upside in realization proceeds through a shared distribution waterfall. At a high level, these structures involve dropping the relevant assets (*i.e.*, fund interests) into an SPV owned by the buyer and the sponsor. The buyer can receive disproportionate distributions until MOIC, IRR or valuation targets are met, and then the seller can retain tail upside or valuation correcting distributions.

These "shared waterfall" transactions are usually more complicated than preferred equity structures and require extensive negotiation, but provide a means for transactions to be consummated in the face of meaningful valuation disagreements. For instance, additional conflicts arise because the new shared distribution waterfall represents a more fundamental reset of the economics of an underlying portfolio. Additionally, any incentivization bonus for the sponsor that would be achieved with a more traditional capital infusion for an underlying portfolio may be diluted by the reduced upside participation in the new shared distribution waterfall structure. These complications layer on top of the cost, diligence and consent issues presented in preferred equity deals.

The market for preferred equity and other private fund liquidity alternatives will evolve as the effects of the covid-19 pandemic permeate the economy. While such options provide opportunistic variety in the market, sponsors should carefully evaluate such structures as this developing market takes shape as there is no one-size-fits-all solution.